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Financial Markets Serve Rural Areas Reasonably Well

Rural financial markets differ from urban markets, but they appear to work reasonably well at supplying credit to rural borrowers. When urban and rural loans are compared, average interest rates, collateral requirements, and other terms are nearly identical. Furthermore, national opinion surveys have generally found that rural borrowers are at least as satisfied with their financial service provider as are urban borrowers. The nature of rural economies—small communities, small borrowers, and undiversified industries—can lead to disparities in the availability of financial services among individual borrowers and communities, but financial market imperfections have not detracted substantially from overall rural growth.

The cost and availability of credit for agriculture and other rural borrowers is a perennial concern of policymakers. Not only is the availability of financial services at competitive prices important for economic growth and development, but economic problems are often blamed on a lack of credit even when limited business prospects, poor managerial skills, or high risk of failure are the underlying causes of the problem. A perception that more money is a solution to perceived problems, together with the low initial budgetary impact of many credit initiatives, combine to fuel interest in Federal credit policy.

As part of its deliberations on the 1996 farm legislation, Congress asked USDA to study rural credit markets to determine how well public and private lenders were serving farmers and rural household and development finance needs, and whether additional sources of credit were needed. This article summarizes the Department's response, as published in *Credit in Rural America.*

Rural Financial Markets Differ From Urban but Generally Perform as Well

Data on commercial banks, the Farm Credit System, Federal financial assistance programs, and a range of other rural lenders—together with information on rural and urban loans and borrowers—show that, on average, rural financial markets work fairly well. Rural financial markets differ from urban markets because of the nature of rural communities. Like rural America in general, rural financial markets are diverse. Sporadic problems exist for some borrowers in some markets, risk financing (such as equity for new businesses and long-term operating loans for businesses and community organizations) is difficult to find, and many rural communities lack competitive banking markets. While undoubtedly important to those affected, overall these problems appear to be minor compared with the other limitations many rural areas face in sustaining growth and are not enough to prevent economic development in most areas.

From a policy perspective, available evidence indicates that "broad-brush" Federal intervention in rural financial markets is not needed and, in most cases, would not be cost-effective. That is, broad attempts to increase the flow of loanable funds to rural areas are unlikely to solve existing problems. Instead, if cost-effective solutions to rural financial market failures exist, they are likely to target specific submarkets (such as equity finance), specific communities (such as those in poor, isolated areas), or specific types of borrowers.

Rural borrowers are served by a wide variety of financial service providers. The most visible sources are regulated financial institutions—particularly commercial banks, savings and loans (for housing), and the Farm Credit System (for agriculture). However, other institutions and individuals play important roles by supplying credit or by

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enhancing the competitiveness of rural financial markets. Table 1 lists the potential sources of credit and financial market support for agriculture and rural housing, business, and development. Retail lenders are responsible for originating loans; the degree of competition among them can determine how efficiently borrowers are served.

Government-supported secondary markets and credit enhancement programs were initiated partly to help foster greater competition for eligible loans. They encourage the creation of new competitors, or increase the size of the market served by existing lenders and increase the lending capacity of financial institutions within a given market. Borrowers do not typically interact directly with the institutions and entities listed in the lower half of table 1. These organizations typically deal with retail lenders, buying eligible loans, serving as conduits or guarantors for the sale of mortgage-backed securities, providing cash advances, and guaranteeing or insuring eligible loans originated by lenders. Nonetheless, their existence has had a marked impact on retail lender behavior and, to varying degrees, on financial market performance.

Three critical issues are: (1) whether rural financial institutions have an ample supply of funds available to finance local economic development, (2) whether rural borrowers pay more for credit than do urban borrowers, and (3) whether rural financial markets satisfy viable demand for credit. For private lenders, our underlying concern is whether financial markets are economically efficient. An efficient financial market offers borrowers equal opportunities by allocating credit to its most profitable uses. But even this equality of opportunity may not yield a socially equitable allocation of resources. For example, the uneven distribution of education and wealth within the U.S. population creates an uneven distribution of creditworthiness that may be politically unacceptable. Concerns over fair treatment of underserved populations

Table 1

Sources of credit for agriculture and rural housing, business, and development

Credit sources vary depending on the nature of the loan

	Type of loan			
Type of lender	Agriculture	Housing	Small business	Community development
Retail lenders:				
Regulated financial institutions—				
Commercial banks	major	major	major	major
Farm Credit System	major	minor	minor	minor
Thrift institutions	minor	major	minor	minor
Insurance and pension funds	moderate	—	minor	—
Unregulated lenders—				
Finance companies	moderate	minor	moderate	—
Mortgage brokers	minor	major	—	—
Trade credit suppliers	moderate	—	moderate	—
Nonprofits (revolving loan funds, etc.)	—	minor	minor	minor
Individuals	moderate	moderate	moderate	moderate
Government direct loan programs—				
U.S. Department of Agriculture	moderate	minor	—	minor
Other Federal agencies	—	minor	minor	—
State and local agencies	minor	minor	minor	major
Secondary markets and credit enhancements:				
Government-sponsored enterprises—				
Federal National Mortgage Association	—	major	—	—
Federal Home Loan Mortgage Corporation	—	major	—	—
Federal Home Loan Bank System	—	major	—	minor
Federal Agricultural Mortgage Corporation	minor	minor	minor*	minor*
Farm Credit System (lending to Other Financial Institutions—OFI's)	minor	—	—	—
Government agencies—				
U.S. Department of Agriculture	moderate	minor	minor	moderate
Other Federal agencies	minor	moderate	moderate	minor
State and local agencies	minor	minor	minor	minor
Private sector—				
Loan poolers	minor*	minor	minor*	minor*
Loan guarantors/insurers	minor	moderate	minor	minor

Note: Precise estimates of the relative importance of specific lenders within rural credit markets are generally unavailable. Categorizations are based on survey data, administrative records, and anecdotal evidence. A major participant provides or supports more than 20 percent of the market; moderate participants handle 5 to 20 percent of the market; minor participants handle less than 5 percent of the market. * = support is provided primarily for federally guaranteed loans. — = not applicable or no significant activity.

Source: ERS calculations based on industry data.

underpin many Federal credit assistance programs. As a result, financial market efficiency often is not the goal (or is only one of several goals) of public programs, but from a rural economic development perspective, reasonably efficient financial markets remain a key to sustainability.

Rural Lenders Have Ample Loanable Funds

The most prominent rural lenders are commercial banks, the Farm Credit System (FCS), savings and loan associations, and Federal credit programs administered by USDA and by other Federal agencies. The commercial banking system is the largest supplier of credit services to rural businesses and development organizations and serves the widest range of borrowers and loan types. Rural banks provide home mortgages, consumer loans, agricultural loans, and commercial/industrial loans. They also hold tax-exempt securities used to finance State and local government activities. As the dominant lender in many markets, rural banks are well positioned to provide the commercial credit needed to finance rural development. Commercial bank capital levels are high, as are profits, while problem loans are low (fig. 1). The banking system as a whole, and rural-headquartered banks in particular, are well positioned to meet the credit needs of rural America as we approach the end of the decade. And while loan/deposit ratios are at historically high levels, surveys indicate that rural bankers are anxious to make loans to creditworthy borrowers. Furthermore, rural banks have an increasing array of nondeposit sources of loanable funds, including:

- Emergency, adjustment, and seasonal lending from Federal Reserve Banks
- Advances from Federal Home Loan Banks and the Farm Credit System
- Securitization of eligible loans through Fannie Mae, Freddie Mac, and Farmer Mac
- The market for Federal funds and repurchase agreements
- Correspondent banks, bankers' banks, and private placement of securitized loans.

These nondeposit sources of funds allow commercial banks to pursue profitable loans with less regard to their core deposits by providing relatively easy access to national money markets.

Other depository institutions, such as savings and loan associations and credit unions, typically serve a much narrower market than commercial banks, but these institutions, too, are well situated to meet the credit needs of their clientele. Savings and loans (S&L's) are a major source of home mortgage credit, and credit unions provide consumer credit to their members. Like commercial banks, S&L's rely heavily on secondary markets to move the loans they originate and service off their books, providing them with a ready source of funds with which to make additional loans. In markets served by S&L's, these institutions act as strong competitors with commercial banks and other mortgage lenders, providing homeowners with a ready supply of mortgage credit. Credit unions rely on low operating outlays to hold down the cost of their loans. Nonetheless, their small size and membership restrictions keep them from being a major source of credit in most rural communities.

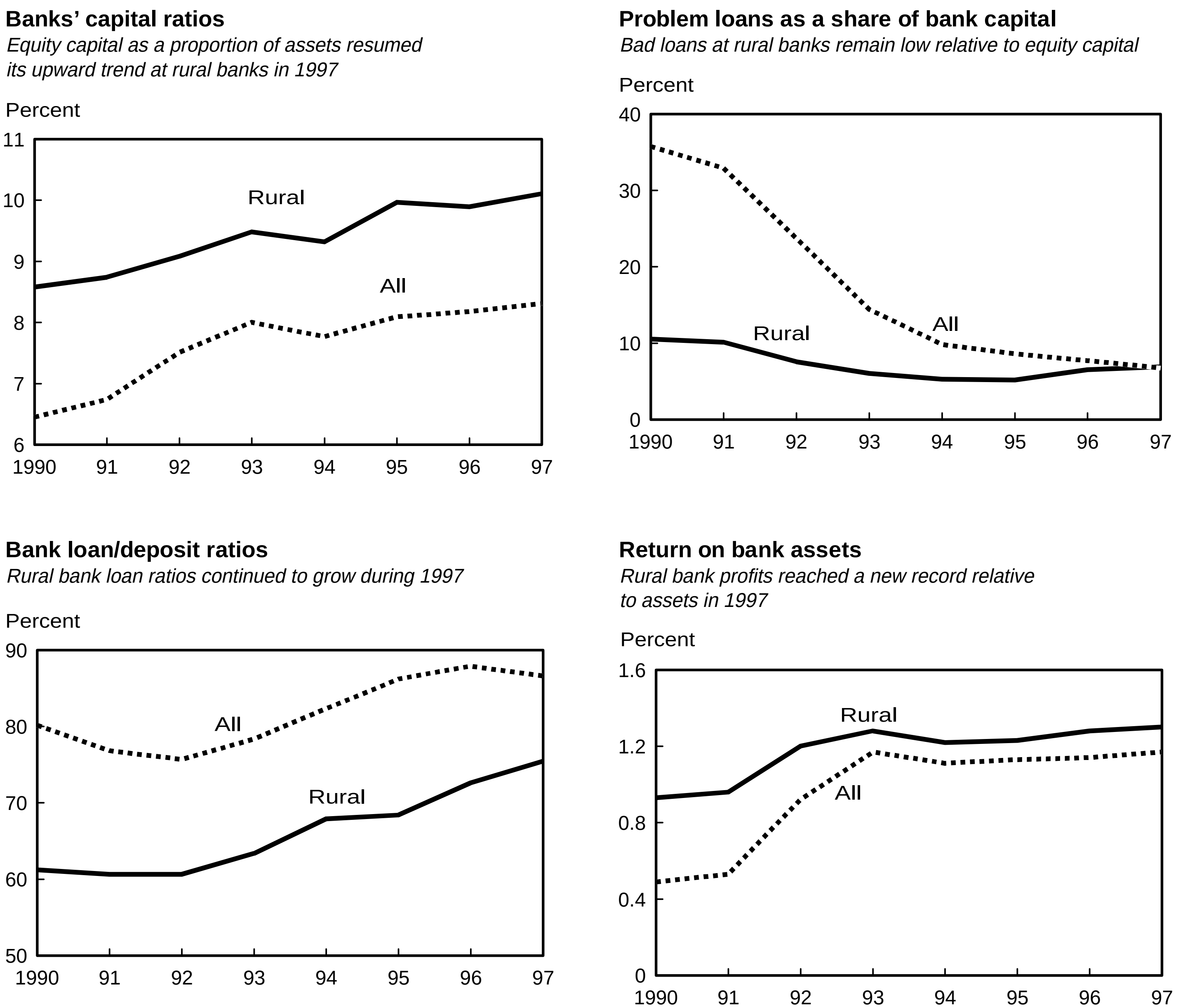
The Farm Credit System (FCS), through its nationwide network of banks and associations, serves as a major source of agricultural credit and a strong competitor for creditworthy farmers. The FCS provides long- and short-term credit for commercially viable farmers, farm cooperatives, farm-related businesses, fisheries, rural housing, rural utilities, and agricultural exports. Based on its status as a government-sponsored enterprise (GSE) and on the sound financial shape of its component banks and associations, the FCS has access to a ready supply of competitively priced loanable funds for eligible borrowers. Unlike other GSE's, the FCS originates and services the vast majority of the loans it holds, putting it in direct competition with other retail lenders. For activities that the System's largely autonomous institutions are authorized to finance, competitively priced credit should be available to qualifying borrowers.

As a group, the major suppliers of commercial credit in rural areas—commercial banks, S&L's, and FCS lenders—are financially strong and able to respond to increases in economic demand. These institutions have increased their lending in recent years and have the ability to meet future demand for commercial credit.

Government Programs Influence Credit Allocation

The Federal Government uses a number of approaches to influence the allocation of credit in the U.S. economy—regulation of financial institutions, tax policies, bankruptcy laws, support for secondary markets, and financial assistance programs (grants, loans, loan guarantees, and technical assistance). We have already discussed how government-sponsored enterprises—such as the FCS, Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, and Farmer Mac—affect the supply of credit. This section briefly covers the wide range of Federal grant and loan programs that provide financing for agriculture and rural housing, businesses, and communities. Federal policies and programs that heighten lender competition, lower transaction costs, or improve information have enhanced financial market efficiency. However, direct lending programs operated by the public sector rarely succeed in allocating capital efficiently and often attempt to address public purposes other than improving financial market efficiency by subsidizing favored borrowers or activities. Even programs that attempt to improve rural financial market efficiency through guarantees and techni-

Figure 1
Commercial bank finances, 1990-97



Source: Calculated by ERS from Federal Reserve Board, Reports of Condition and Reports of Income, December 31, 1990-97.

cal assistance often involve subsidies for favored lenders or borrowers, requiring targeted program eligibility rules.

While not credit per se, grants are an obvious substitute for credit in delivering financial resources to spur rural development. Indeed, from an economic efficiency perspective, grants are often superior to credit for dealing with fairness issues. They can provide the subsidies needed to arrive at a "fair" allocation of resources without burdening the recipient with debt repayment obligations. Grants can also help alleviate credit market inefficiencies related to high transaction costs and provide seed funds for new competitors.

Grant programs are most prevalent for public infrastructure and community development projects, but also support the provision of low-income housing and technical assistance. In fiscal year 1996, rural areas received roughly $100 per capita for infrastructure and community development—far more than for any other purpose (table 2). Of all grant funds that were allocated to the county level, rural areas received approximately $170 per capita—about 93 percent of the urban level.

Direct loans are originated and often serviced by a Federal agency. For the past two decades, the Government has been reducing its direct lending activities in favor of programs, such as loan guarantees, that encourage greater private sector lending. However, a number of Federal agencies continue to operate direct loan programs for specific borrowers qualifying for subsidized credit, such as victims of natural disasters and limited-resource borrowers. While direct loan programs can require large administrative staffs to ensure that funds are properly targeted, they are appropriate for delivering highly subsidized credit because, like grant programs, they maximize the Government's control over allocation decisions. In fiscal year 1996, roughly $115 per capita was received by rural borrowers through direct loan programs, far more than was received by urban borrowers.

Loan guarantees and insurance now dominate Federal agency lending activities. With a loan guarantee or insurance program, the Government leaves the origination and servicing aspects to private lenders, which many believe have comparative advantages over government agencies in these activities. The guarantee / insurance lowers or completely removes the risk of default losses on loans to qualified borrowers, increasing lenders' willingness to supply them with credit. The fact that the loans are backed by the Federal Government also reduces the amount of capital that lenders are required to hold on outstanding loans and increases their liquidity. The increased liquidity resulting from Federal loan guarantees / insurance may allow participating lenders to make more loans—of all types—than they would otherwise. In 1996, rural areas received over $180 per capita in federally guaranteed / insured loans—far less than the $409 per capita received by urban communities. Housing accounted for half of the rural allocation, with the remainder going mostly to farms and other rural businesses.

In addition to financial support, various Federal agencies also provide technical assistance directly to farmers, businesses, and communities. Technical assistance helps borrowers plan and implement economically sound development projects. The USDA's extension system, the U.S. Department of Commerce's Manufacturing Extension Partnership, and the Small Business Administration's Small Business Development Centers all provide technical assistance to rural borrowers. Technical assistance is also provided by supervised credit programs administered by Federal agencies or with Federal funds.

Technical assistance is unique as a credit-enhancement technique because it fundamentally improves the quality of credit demand rather than its supply. Credit (unless it is merely a disguised income transfer) requires repayment. To qualify for commercial credit, households, businesses, and governments must demonstrate the potential to satisfactorily make loan payments on a timely basis. Through its technical assistance programs, the Federal Government improves the ability of recipients to carefully manage their household, business, or public budgets, thereby improving their qualifications for commercial loans. The supply of credit is not altered per se, but its availability to underserved populations may be.

Given the nature of Federal programs, determining whether sufficient funds are available to meet program goals is difficult, but relative to urban areas, rural areas

Table 2

Federal financial assistance program outlays for economic development, 1996

Rural areas received slightly less grant money, more direct loan funds, but far less guaranteed/insured loan funds per capita than urban areas

Purpose and location[1]	Type of assistance: Grants	Loans	Guarantees
	Dollars per capita		
Agriculture:			
Rural	1.65	72.89	27.40
Urban	1.22	9.25	1.77
Housing:			
Rural	66.52	24.18	95.49
Urban	109.12	9.88	358.49
Business:			
Rural	.62	5.03	41.83
Urban	.16	5.31	42.70
Community development:			
Rural	101.72	12.56	16.83
Urban	73.15	1.04	5.63
Total:			
Rural	170.51	114.66	181.55
Urban	183.65	25.48	408.59

[1]The purpose of each Federal program is based on the primary activities funded. For a listing of the types of programs included in each category, see *Credit in Rural America*. Location is determined by each county's inclusion or exclusion in a Metropolitan Statistical Area as defined by the Office of Management and Budget.

Source: Calculated by ERS from the Census Bureau's *Consolidated Federal Funds Report, 1996*.

appear to receive their fair share in most cases. While specific programs have marked geographic patterns and the form in which assistance is provided differs between urban and rural areas, the only area in which the level of assistance provided to urban borrowers far exceeds that provided to rural borrowers is in guaranteed / insured housing loans. Part of this difference reflects the way data are reported, but even so, rural borrowers and their lenders clearly rely less on Federal housing loan programs than do their urban counterparts.

Rural and Urban Interest Rates Are Similar

Measures of credit market performance rely heavily on comparisons of the cost of credit. Significantly higher average risk-adjusted effective interest rates on rural loans compared with similar urban loans would provide strong evidence of widespread rural credit market problems. However, comparing simple averages of interest rates on rural and urban loans can be misleading because interest is only part of the cost of credit and depends critically on the risk of default a particular borrower represents. The interest rate comparisons presented in the literature adjust for some of the factors that can distort such comparisons, but sufficient information simply is not available to precisely measure the risk-adjusted cost of credit in either rural or urban markets. As a result, the available evidence is somewhat inconclusive but suggests that the performance of rural and urban credit markets is comparable.

USDA's *Credit in Rural America* includes comparisons of average interest rates on rural and urban SBA section 7(a) guaranteed small business loans and home mortgages originated during 1995, controlling for as many cost-related factors as the data support. In neither case did average interest rates differ greatly. Earlier research based on the Federal Reserve Board's National Survey of Small Business Finance found rural and urban interest rates virtually identical for similar types of business loans, with few significant differences in loan terms apparent on the typical rural and urban small business loan. Analysis of a 1995 survey of the National Federation of Independent Business membership also found that rural business firms were more concerned with credit availability than they were about its cost. Rural respondents generally thought their primary financial institution was a reliable source of credit.

When interest rates on home mortgages were compared, most types of home mortgages were slightly more expensive in rural areas in 1995. However, disparities were typically small and consistent with the greater cost of doing business in sparsely populated areas. Recent data on community development financing is not readily available, but 1980's research comparing the borrowing costs of rural and urban governments found no appreciable difference in interest rates paid on tax-exempt bonds when cost-related factors, such as bond rating and issue size, were accounted for.

Given the data limitations faced by all such comparisons, rural borrowers generally appear to pay roughly the same average interest rate on loans as their urban counterparts. In those cases where evidence of higher rates exists, the disparity rarely seems to be greater than could plausibly be explained by the greater cost of doing business in sparsely populated areas. One area of continuing concern, however, is the cost and availability of risk capital. A lack of data precludes much discussion about equity financing for new businesses, but anecdotal evidence suggests that markets serving high-risk ventures may be less developed in rural areas. While equity financing is difficult to arrange for any risky venture, the informal nature of startup capital markets and the premium placed on having a pool of managerial and technical expertise available to support the entrepreneur / project director both suggest that risk capital may be easier to arrange within urban settings.

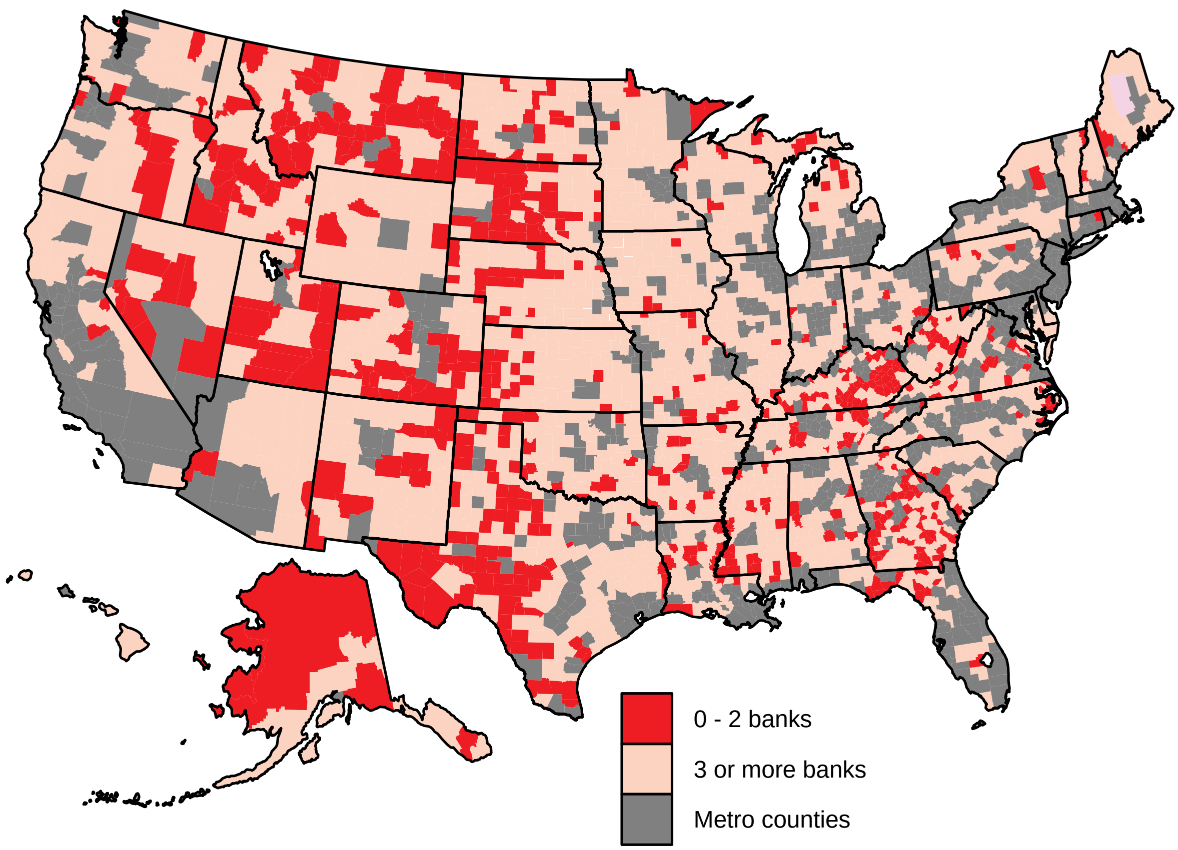
Rural Financial Market Structure Is a Continuing Concern

While rural credit is ample and interest rates are comparable to those offered in urban areas, the structure of rural financial markets is a continuing cause for concern. Rural communities typically have far fewer lenders than urban communities, and financial market segmentation further reduces competition among existing lenders. National averages can mask a considerable amount of variation in local financial market conditions; the absence of competitive pressures in some rural markets raises concerns that some rural borrowers may be at a disadvantage in acquiring credit.

Despite rapid consolidation within the banking industry nationwide, the number of competing banks within local financial markets has remained remarkably stable over the past 15 years, perhaps because of potential antitrust enforcement by the Department of Justice and bank regulator concerns over the community impacts of mergers. Still, in June 1997, 26 percent of rural counties were served by two or fewer banking firms, with all of a bank's branches and all the affiliates of a multibank holding company counted as one firm (fig. 2). In contrast, 45 percent of urban counties were served by 10 or more banking firms. Competitive financial markets are more likely to allocate loanable funds efficiently and offer credit at interest rates that reflect anticipated risk.

Financial markets are segmented by geographic location, loan riskiness, and loan terms, including size, term to maturity, collateral, and purpose. Institutional design and regulation create barriers to market entry that sustain this segmentation. The structure of Federal and State programs, GSE charters, and banking laws has encouraged

Figure 2
Rural counties served by two or fewer commercial banking firms
Sparcely populated and poor counties have few competing banks



Source: Summary of Deposits tape for June 1994, Federal Deposit Insurance Corporation.

segmentation in agricultural, housing, and business loan markets. For example, struggling and low-resource farms are served through Federal and State direct and guaranteed loan programs, part-time farmers primarily through commercial banks, and large commercial farms through the FCS and insurance companies. A similar stratification and segmentation occurs in housing and business credit markets. Various barriers and competitive advantages—including subsidies, capitalization rules, location of lending offices, and organizational structures—sustain this segmentation. Segmentation per se is not necessarily a problem if each market segment is competitive. However, in sparsely populated rural economies, financial market segmentation can support noncompetitive pricing and lending behavior, which can retard the economic development of affected groups and communities.

Financial market problems are most likely to affect borrowers in small, isolated communities who depend heavily on local lenders for their credit needs. Marginally creditworthy institutions, firms, and households—those whose loans may have trouble qualifying for secondary markets when such markets exist—and small entities needing relatively small loans are likely to rely heavily on local lenders. The more isolated their communities are from competitive banking markets, the more likely local lenders will feel free of competitive pressure. But there are limits to how inefficient credit market allocations can become, even in the most remote one-bank town. Nontraditional lenders and other financial institutions are always ready to move into market niches, particularly if the potential for above-average profits substantially outweighs the costs of market entry.

Rural Credit Markets Sound, but Localized Disparities Remain

The commercial banking system, savings and loans, and the Farm Credit System are in sound financial shape and have access to an ample supply of loanable funds to meet the commercial credit needs of qualified rural borrowers. Access to loanable funds does not appear to be a problem for rural lenders. Based on the limited data available for similar loans in urban and rural areas, the cost of credit appears to be comparable; that is, no evidence was found that rural borrowers pay appreciably higher interest rates than urban borrowers, on average. The differences that were found were small and, in the case of conventional home mortgages, consistent with the presumed higher costs of servicing sparsely populated settings.

Nonetheless, overall averages can mask significant disparities among individual borrowers and communities. The general characteristics of retail banking markets (for example, many relatively uninformed borrowers, substantial information and transactions costs for both borrowers and lenders, a small number of lenders in many local markets, and barriers to entry by other lenders) make them vulnerable to financial market imperfections and may allow lenders in some markets to operate less efficiently than they would otherwise in competitive markets (Rhoades). In addition, most retail lenders are not major sources of credit for all borrowers, and they often specialize in providing particular types of loans or serving particular risk classes of borrowers within the markets they serve. The resulting segmentation of credit markets along product, geographic, and borrower characteristic lines further reduces competition among lenders. Such market conditions may result in higher prevailing interest rates or, more troubling, fewer creditworthy loans being made. However, market forces limit the size of such impacts, since new or nontraditional lenders invariably respond to attractive market opportunities.

In sum, no evidence of widespread or economically important market failures or imperfections has been found. Concerns remain that the structure of many rural financial markets may enable inefficient or noncompetitive practices that could slow growth in rural areas. And the most efficient financial market will not address the credit needs of those who fail to qualify for commercial credit because of legitimate creditworthiness concerns. But these concerns require measured policy responses. Broad-brush Federal initiatives that attempt to increase the flow of loanable funds to rural areas will not address the types of sporadic problems that are likely to exist in rural America. In addition, credit problems by themselves are unlikely to be the only barriers to growth in stagnating economies. Policies addressing the educational and skill levels of the rural workforce, the cost of getting to markets, the availability of nonfinancial business and personal services, and government regulations are likely to have an equal or greater effect on rural development.

For Further Reading. . .

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